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Asia's rollercoaster rides

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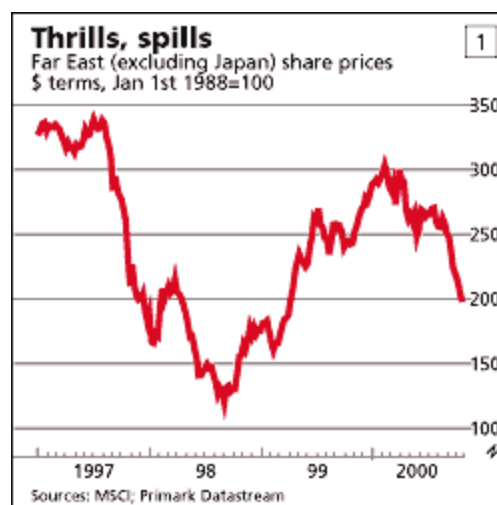


The oil-price rise will hurt many of East Asia's recovering economies, especially if electronics exports also slow. But the ride will be rougher in some parts of the region than others

IF YOU crave excitement, try strapping yourself into East Asia's stockmarkets. Across the region, those markets continue to offer investors white-knuckle rides. First there was the free fall of 1997-98, followed by last year's stunning rebound, then by another breathtaking plunge beginning in March 2000 (see chart 1). East Asia fell faster than any other region in the third quarter of this year, and contains many of the world's worst-performing indices. Several markets have fallen by at least 40% this year in local-currency terms; many have now lost all of last year's gains. But might these Nasdaq-like performances be the prelude to something even worse?

The sell-off continued this week, driven by troubles in the Middle East and more turmoil in America's stockmarkets. Moreover, the bad news comes at a time when East Asian economies are already showing signs of slowing, after the crisp "V-shaped" recovery of the past two years. And, as many countries have been lax about cleaning up bad debts, a weaker expansion could generate all sorts of fresh problems.

For this year, the consensus is cheerful, to judge by *The Economist's* latest quarterly poll of forecasters (see chart 2). It suggests that the region—excluding recovering China and giant but torpid Japan—will record real GDP growth of more than 7% in 2000. This grouping includes the eight economies most badly affected by the collapse of 1997-98. The average masks some sharp differences between



countries: industrialised economies such as Singapore, South Korea and Hong Kong are growing rapidly, whereas stragglers such as Indonesia, Thailand and the Philippines are expanding by only 3-5% a year. But it gives an idea of how strongly the region has rebounded from its recession.

But what of next year? It is increasingly apparent that some East Asian countries are poorly placed to weather a cooler global climate. Since the news from elsewhere has been bad lately, that is what they are now facing.

However bad the news, few people in Asia now fear a repeat of the financial crisis that triggered the collapse of mid-1997. Two striking changes have occurred since then: short-term foreign debt levels are more manageable and foreign-exchange reserves higher. Both ratios were good predictors of how countries fared during the crisis, and over the past two years both have improved across the region. Central banks have used strong current-account surpluses to build up reserves; and, although high debt levels will continue to be a drag on growth, restructuring and repayments have lowered the foreign, short-term component. But, even though the basic health of most East Asian economies has improved, there is still a debate about how vulnerable they may be to external shocks.



The pessimists note that one of the main drivers of East Asia's recovery has been growth in exports, most notably of electronics. A slowdown in the OECD countries, and especially in America, could cause demand for those exports to stall.

Add to that the rise in oil prices, which after a brief respite shot to nearly \$36 a barrel during last week's violence in the Middle East, sending shivers through Asia. Apart from Indonesia and Malaysia, East Asia's economies are avid oil importers. Indeed, their recovery, together with OPEC's supply changes, helps to explain the rebound of oil prices from the fall that their collapse had previously exacerbated. High oil prices would cut into current-account surpluses and squeeze the profits of over-indebted companies. With growth expected to taper off anyway next year, these are serious threats. Our consensus poll—taken before last week's events—was already forecasting a slowdown of nearly two percentage points in 2001, to 5.2% GDP growth. Some of that slowdown is cyclical and manageable; but, if the poll turns out to be too cheerful, the region's debt problems could cause trouble.

The optimists, however, argue that the region should welcome the prospect of a mild slowdown in America. East Asia has suffered huge outflows of foreign funds this year. And although rising inflation means that the region's real interest rates are low on average, this has yet to translate into fresh lending. So some optimists have argued that the gains from lower interest rates and, potentially, fresh inflows of funds, would offset—at least partially—any loss in electronics exports. This might also boost consumer demand and intra-regional trade.

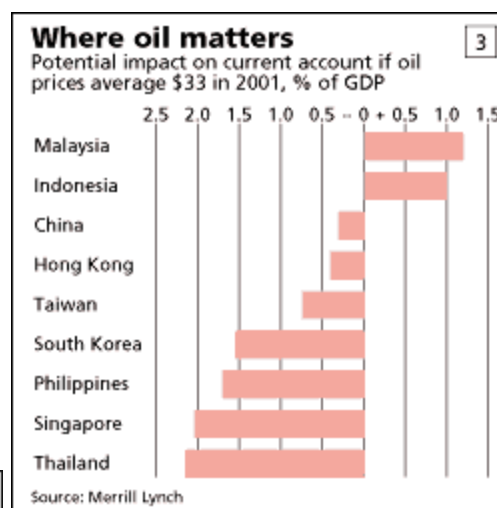
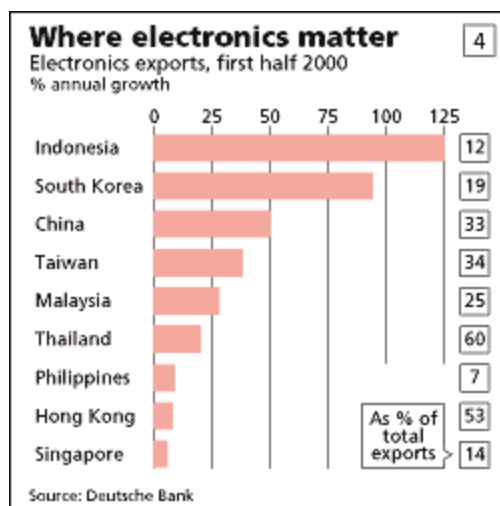
That cheerful outcome would be reinforced if Japan's economy were to pick up the slack: strong capital spending could boost consumer demand next year, just as the region needs it. Chris Wood, a regional analyst at ABN Amro in Hong Kong, points out that the last regional stockmarket rally, which began in late 1998, started in circumstances rather similar to today's: there were widespread forecasts of doom and gloom (remember Long-Term Capital Management?), but these were beaten back by the anticipation of falling interest rates.

Good bets

One problem with this debate is that the optimists and pessimists are probably both right. Changing global winds will blow differently through the region's individual economies (see charts 3 and 4).

To see why, start with the most likely winners: the two island financial centres of Hong Kong and Singapore. Hong Kong, especially, has lots to gain from slower growth in the United States and a weaker dollar. It is partly insulated from what happens across the Pacific by its close economic ties with the Chinese mainland, which is expected to be the fastest growing economy in East Asia in 2001. And a weaker dollar would boost Hong Kong's banking and property sectors. These two sectors are already enjoying a rally; yet, because of its currency board, the Hong Kong dollar has risen along with the American dollar this year, as have local interest rates. Hong Kong would also benefit from any regional flight to quality.

Unlike Hong Kong, Singapore is exposed to some of the same export risks as its neighbours: a sharp slowdown in America would hurt demand for electronics and other exports. But an American-led slowdown would benefit Singapore in much the same way as it would boost Hong Kong. Indeed, the balance of forces affecting Singapore resembles, in some ways, the balance facing other East Asian economies.



Although Singapore was affected by the regional crisis, the government used the opportunity to push for business and financial reforms. Real GDP grew by more than 10% year-on-year in the third quarter, and the economy is now running roughly at capacity. Any fall in world interest rates would boost both its financial firms and, probably, its stockmarket. That in turn would make it easier for the markets to absorb an expected spate of equity offerings by government-linked companies, and so give a further boost to supply-side reforms.

In short, Singapore would probably benefit from an American slowdown because it has more to gain from falling interest rates than it has to lose from weaker demand for electronics and dearer oil. The debate over East Asia's prospects hinges on how far other economies can make the same claim.

Bad bets

By general agreement, three economies clearly cannot do so. These are the basket cases of Indonesia, Thailand and the Philippines. Although there are distinct differences in these economies, few foreign investors are still around to notice. That alone is one of these economies' biggest problems. They have tiny market capitalisations and have made little progress in selling

state assets. So most asset managers see no reason to comb through individual companies' prospects or spend much time in their capitals. Instead, they make blanket decisions based on the most visible news, most of which is political and almost all of which is mind-bogglingly bad.

To counter such gloom, it is worth pointing out that Indonesia is a big net exporter of oil. Unfortunately, that concludes the good news. Its year-old government still lacks momentum, and continues to put out conflicting messages. Its president has devoted little political capital to pursuing powerful debtors or pushing through asset sales. After a 14% implosion in 1998, and zero growth last year, the economy is finally putting out decent numbers and heading towards a 4-5% expansion this year. But unless policies change radically, it is hard to see Indonesia doing much better in the near future. Since most of its problems are political, and slow growth exacerbates those problems, the country could easily remain caught in a trap.

Thailand's problems are similar but milder. There too, politics now dominates much of the chatter, partly because an election is due by the end of the year. There are fears that the next government will veer down a more nationalist and less reformist path. Even if it does not, bad loans are more likely to be recycled than repaired.

In fact, Thailand may be growing at a decent pace. It is hard to be sure, because radical swings in asset prices over the past few years have muddled up the inflation numbers. Different measures inflation—or deflation—suggest wildly different estimates of real growth. Richard Henderson, of Kim Eng Securities in Bangkok, has got around this by creating a new output index based partly on electricity usage. It suggests that growth was much higher in the first half of this year than the official estimates indicate: perhaps 7-8% year-on-year. But even he expects growth to slow down by next year, as inventories stop piling up.

And then there is the Philippines, which has begun to contest Indonesia as the region's most hopeless case. Although the country was originally less affected by the regional collapse, its fiscal deficit is now exploding. The government may turn in a shortfall of twice its original target. The currency has blown through several support levels, and is now trading near an all-time low of almost 49 pesos to the dollar. Imports of manufacturing inputs, a crucial leading indicator, have collapsed. The president, who has faced numerous scandals, is now facing louder calls for impeachment. The best hope of economic expansion is a potential spending spree by candidates in next May's congressional elections—a prospect that is hard to spin into a compelling long-term growth story.

There are few signs that these countries will come to grips with their financial problems. And, since they are already growing slowly—especially for emerging economies in the first stages of recovery—a couple of percentage points off their growth rates is a worrying prospect. Whereas China, Hong Kong and Singapore could shrug off a global slowdown, the healthiest response for these laggards would be to panic—constructively, of course.

Worth watching

If you really want to know where the region is heading, however, it is the economies between these extremes that will be most worth watching in the coming months. Malaysia, South Korea and Taiwan have all bounced back sharply from the recession of two years ago, and are growing strongly this year. Moreover, Taiwan initially escaped the worst aspects of the regional crisis, emerging with only a modest level of bad loans. And, although Malaysia and South Korea—which together with the three laggards rounded out the so-called "Crisis Five" countries—suffered troubling debt problems, their bad loans and debt ratios never reached the same proportions as in their counterparts. The ratio of debt-service levels to exports, for example, is only around 6% in both countries, compared with 20-30% in Thailand, Indonesia and the Philippines.

Just six months ago, therefore, these three economies provided compelling evidence, when lumped in with China, Hong Kong and Singapore, of a region that was mounting an impressive comeback. If one ignored the fortunes of South-East Asia's basket cases, with their messy democracies and puny stockmarkets, there were reasons for optimism all round.

Yet now, all three of those middling economies are in danger. Some of the reasons differ, but a common theme is those electronics exports. By most estimates, Taiwan is the most heavily exposed, but Malaysia and South Korea would also be badly affected by weaker demand.

Nor would these economies gain as directly as the island financial centres would do from lower world interest rates. Taiwan additionally faces rising bad loans; the other two countries, growing disappointment with their restructuring efforts. So these economies are the swing voters, as it were, in any attempt to judge East Asia's outlook. And, as the global risks mount, so their prospects become gloomier.

Malaysia looks strong: it boasts one of the least disappointing stockmarkets in the region, having fallen by less than 10% this year. Its recovery has been fed by booming electronics exports that have funnelled liquidity into the banking system, and from there, until recently at least, into the stockmarket. Moreover, for all of its berating of the IMF, Malaysia's government did a better job than most of its neighbours of following the fund's advice. It set up a pair of agencies quickly to recapitalise banks and help restructure bad loans. Although accusations of political meddling and corruption continue to mar some of these deals, Malaysia has nevertheless had to spend far less than its neighbours on cleaning up the problem.

Yet Malaysia now has good reasons to worry. Although domestic credit is beginning to expand again, corporate lending for investment may not replace consumer loans for homes and cars. Because foreign direct investors continue to shun the place, exports and consumption must bear most of the burden of economic expansion. Since it is exports that have fuelled the consumption boom, and since electronic goods have been a crucial component of exports, the economy looks increasingly vulnerable.

To the east, even bigger troubles are brewing in Taiwan and South Korea. Both countries have been badly affected by what Mr Wood calls the "telescopic" effect of America's Nasdaq. The obsession with America's technology, media and telecoms shares, he argues, has rubbed off on Asia, with investors rushing into similar shares in regional markets. But, since there are fewer such companies to invest in, the effect has been to swell the importance of a handful of stocks—such as South Korea's Samsung Electronics and Taiwan's TSMC—in local indices. As fund managers continue to buy these stocks to keep pace with the index, the imbalance has become absurd.

Both markets boast large numbers of retail investors, who are both a liability and a ray of hope. The risk is that the presence of these investors will lead to a much larger "wealth effect" than in neighbouring countries, as investors respond to falling share prices by cutting back on consumption.

The ray of hope will break through if Morgan Stanley Capital International's popular international stock index is altered, perhaps in early December, to place more weight on the percentage of a firm's shares that are publicly traded. Unlike most of their Asian neighbours, which have large government holdings or shares held in family pyramid structures, South Korea and Taiwan will probably earn higher weightings in the index. That could attract new portfolio money.

Both economies will need some kind of boost to turn things around. Taiwan, a star performer throughout much of the crisis, is now showing clear signs of faltering. Shares of electronics companies have been leading the way down, prompted by fears of a downturn in the

semiconductor cycle, depressing the currency. And bad loans are beginning to rise.

South Korea could also find itself in choppy waters. As charts 3 and 4 show, it would be one of the biggest losers in the region both from a rise in oil prices and from a slump in demand for electronics. Some analysts predict that the current account could swing into deficit next year if the global outlook gets much worse. In addition, South Korea is burdened with 80 trillion won (\$70 billion) of corporate bonds that must be refinanced by the end of next year. When America's Ford recently withdrew its bid for Daewoo Motor, the market shuddered.

The three middling economies may yet do well. Malaysia and Korea are growing strongly, and are expected to continue doing so next year. While Taiwan is growing less strongly, it is the most robust of the three economies, and should be able to handle any rise in bad debts. Moreover, weakness on Wall Street and falling interest rates would bring some benefits. Both Taiwan and South Korea could potentially attract new money; and Malaysia, which still pegs its currency to the dollar, would enjoy a boost in competitiveness, just as it did in late 1998 and last year.

Moreover, both South Korea and Taiwan are worth watching for another reason. Apart from supplying signals about East Asia's strength, they are also two of the world's biggest emerging markets, and are therefore engines of growth for its smaller economies. South Korea's GDP, for example, is nearly \$500 billion—compared with around \$550 billion for the five biggest South-East Asian economies combined. If these economies can pull through, and if Japan's imports pick up, the resulting boost in regional demand will make it easier for the others to weather a global downturn. If things go the other way, though, watch out. The drop may not be as sensational as it was in the late 1990s, but it will still be a nasty jolt.

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